Report

of the

Examination of

Capitol Specialty Insurance Corporation

Madison, Wisconsin

As of December 31, 2001

**TABLE OF CONTENTS**

**State of Wisconsin** / OFFICE OF THE COMMISSIONER OF INSURANCE

***Jim Doyle,*** *Governor*
***Jorge Gomez,*** *Commissioner*

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May 27, 2003

Honorable Jorge Gomez
Commissioner of Insurance
State of Wisconsin
121 East Wilson Street
Madison, WI 53702

Commissioner:

In accordance with your instructions, a compliance examination has been made of the affairs and financial condition of:

CAPITOL SPECIALTY INSURANCE COMPANY
Madison, Wisconsin

and this report is respectfully submitted.

## I. INTRODUCTION

The previous examination of the company was conducted in 1997 and 1998 as of December 31, 1996. The current examination covered the intervening period ending December 31, 2001, and included a review of such 2002 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

History
Management and Control
Corporate Records
Conflict of Interest
Fidelity Bonds and Other Insurance
Employees' Welfare and Pension Plans
Territory and Plan of Operations
Affiliated Companies
Growth of Company
Reinsurance
Financial Statements
Accounts and Records
Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The company qualified as exempt from filling an annual audited financial report by an independent public accounting firm with the Commissioner pursuant to s. Ins 50.02, Wis. Adm. Code, because there was no direct or assumed premium in 2001. Accordingly, the company was not audited in 2001. However, the company expects to be audited on a consolidated basis with its affiliates beginning in 2002. Alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

## II. HISTORY AND PLAN OF OPERATION

Capitol Specialty Insurance Corporation (hereinafter also “Capitol Specialty” or the “company”) was organized in 1961, as All-Star Title Insurance, Inc. The company’s name was changed to Capitol Land Title Insurance, Inc., in 1966, when its then ultimate parent Capitol Transamerica Corporation (hereinafter also “Capitol Transamerica” or “CTC”) purchased the company. The company adopted its current name effective November 30, 1993.

Effective January 4, 2002, Alleghany Corporation (hereinafter also “Alleghany”) announced the closing of a merger agreement under which Alleghany purchased CTC for approximately $182 million in cash. Prior to the purchase CTC was a publicly traded company whose common stock was traded through the National Association of Securities Dealers.

Effective March 31, 2002, Capitol Specialty was contributed to its then sister affiliate Capitol Indemnity Corporation. For additional information related to affiliates see the section of this report titled “Affiliated Companies”. Additional information regarding the purchase by Alleghany is discussed further in the section of this report titled “Appendix-Subsequent Events”.

The company is licensed only in the state of Wisconsin, and is approved on a nonadmitted basis in Kansas, Oklahoma and Washington. The company has not written any direct premium since 1996 and has not had any net premium written during the period under examination. However, management expects to write on a surplus lines basis in various other jurisdictions beginning in 2003.

Capitol Specialty’s only business during the examination period was assumed reinsurance for group dental policies providing out-of-plan covered services written in the state of Illinois, and group dental policies providing either network or non-network plan indemnity coverage written in the state of Michigan. The business was 100% retroceded to an affiliate, Capitol Indemnity Corporation. In 1999, Capitol Indemnity Corporation directly assumed this business and Capitol Specialty has since been inactive.

## III. MANAGEMENT AND CONTROL

**Board of Directors**

The board of directors consists of five members who are elected annually. Officers are elected at the board's annual meeting. Members of the company's board of directors may also be members of other boards of directors in the holding company group. Inside board members receive no additional compensation for their service. Outside board members receive a total of $650 per meeting for service on all boards within the Alleghany Insurance Holdings Group.

Currently the board of directors consists of the following persons:

| Name and Residence | Principal Occupation | Term Expires |
|---|---|---|
| Paul J. Breitnauer<br>DeForest, WI | President and Chief Executive<br>Officer – Capitol Indemnity Corp. | 2003 |
| Dorthea C. Gilliam<br>Hinsdale, IL | President<br>Alleghany Consulting Inc. | 2003 |
| Richard N. Latzer<br>Hillsborough, CA | Former Director of<br>Transamerica Investment Services, Inc. | 2003 |
| David F. Pauly<br>Madison, WI | Chief Operating Officer<br>Capitol Indemnity Corp. | 2003 |
| James P. Slattery<br>New Canaan, CT | Officer<br>Alleghany Corporation | 2003 |

**Officers of the Company**

The officers appointed by the board of directors and serving at the time of this examination are listed below. Listed compensation is total gross earnings for services rendered to the Alleghany Insurance Holdings Group.

| Name | Office | 2002 Compensation |
|---|---|---|
| James P. Slattery | Chair of the Board | * |
| Paul J. Breitnauer | President and Chief Executive Officer | $402,577 |
| David F. Pauly | Executive Vice President, Chief Operating Officer, and Secretary | 296,573 |
| Thomas K. Manion | Vice President, Treasurer, Chief Financial Officer, and Assistant Secretary | 233,186 |
| John J. Burns, Jr. | Vice President | * |
| Richard W. Allen | Vice President Non-Contract Surety Business | 178,882 |
| Edward H. Halloran | Vice President – Underwriting | 134,773 |
| Kent R. Lawson | Vice President – Property & Casualty | 96,212 |
| Robert F. Miller | Vice President – Claims | 103,951 |
| James C. Schlacks | Vice President – Marketing | 96,577 |
| Diane West | Vice President – Human Resources | 46,693 |
| James W. Smirz | Vice President – Fidelity & Surety Claims and Assistant Secretary | 144,581 |
| Frank S. Zillner | Vice President – Information Systems | 165,359 |

* - No compensation is allocated to the company for these salaries.

**Committees of the Board**

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below:

**Executive Committee**
James P. Slattery, Chair
Dorthea C. Gilliam
David F. Pauly

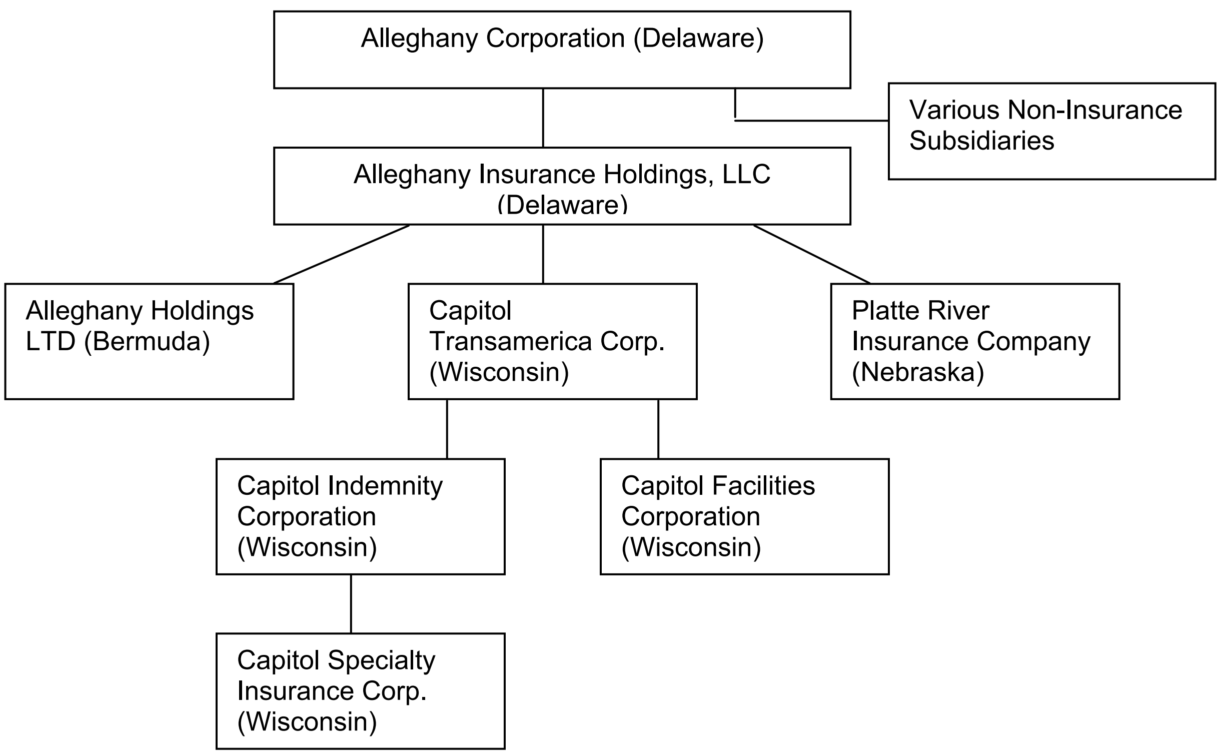
**Investment Committee**
Richard N. Latzer, Chair
Dorthea C. Gilliam, Vice Chair
James P. Slattery
Thomas K. Manion, Secretary

## IV. AFFILIATED COMPANIES

As noted earlier, effective January 4, 2002, Alleghany Corporation (hereinafter "Alleghany") announced the closing of a merger agreement under which Alleghany purchased CTC for approximately $182 million in cash. Due to the timing of this change the following discussion of affiliates will present the relationship as of March 31, 2002. For additional information related to this change in control see the section of this report titled "Appendix-Subsequent Events."

Capitol Specialty Corporation is a member of a holding company system. The organizational chart below depicts the relationships among the affiliates in the group. A brief description of the significant affiliates follows the organizational chart.

**Organizational Chart**
**March 31, 2002**



**Alleghany Corporation**

Alleghany, a Delaware holding company, was incorporated as a business corporation in 1986 under the laws of the state of Delaware. The Delaware corporation succeeded the original Alleghany Corporation, a Maryland corporation that was incorporated in 1929. Alleghany is engaged in the industrial minerals business through its subsidiaries, World Minerals Inc., Celite Corporation and Harborlite Corporation. Alleghany conducts a steel fastener importing and distribution business through its subsidiary, Heads & Threads International LLC. Alleghany is also engaged in property, casualty, fidelity and surety insurance businesses through its indirect subsidiaries, Capitol Transamerica Corporation and Platte River Insurance Company. In addition, through another subsidiaries, Alleghany Properties, Inc, Alleghany owns and manages properties in California.

As of December 31, 2001, Alleghany's audited financial statement reported assets of $1,875,005,000, liabilities of $484,423,000, and stockholder equity of $1,390,582,000. Operations for 2001 produced net earnings of $224,230,000.

**Alleghany Insurance Holdings LLC**

Alleghany Insurance Holdings LLC (hereinafter "AIHL") is a wholly owned subsidiary of Alleghany Corporation. AIHL was formed in 2000 in the state of Delaware. AIHL is intended to function as the holding company for all insurance operations for Alleghany. AIHL operations include run-off operating activities from insurance entities previously owned by Alleghany.

As of December 31, 2001, the company's financial statement reported assets of $142,956,000, liabilities of $(172,010,000) and stockholder equity of $314,966,000. Operations for 2001 produced net loss of $234,340,000, which includes a loss on discontinued operations of $201,267,000.

**Capitol Transamerica Corporation**

Capitol Transamerica Corporation (hereinafter "CTC") is a wholly owned subsidiary of Alleghany Insurance Holdings, Inc. CTC was organized in 1965 for the purpose of acquiring the outstanding stock of Capitol Indemnity Corporation and Capitol Specialty. Prior to its purchase by Alleghany, CTC was a publicly traded company through the National Association of Securities

Dealers under the symbol “CATA”. CTC was responsible for legal and other corporate expenses prior to the Alleghany transaction. Its sources of revenue are investment income, dividend income from subsidiaries, and fee income charged to subsidiaries. The fee income relates to charges for usage of depreciable assets and for rental space. CTC owns all depreciable assets within the Capitol family of companies and is also the named tenant for office space leased. It charges the related companies monthly fees for usage of such assets and space based on estimated actual usage by the various individual companies.

As of December 31, 2001, the company's audited financial statement reported assets of $144,182,657, liabilities of $2,330,481, and unassigned funds and special reserves of $141,852,176. Operations for 2001 produced net loss of $13,153,883.

**Capitol Indemnity Corporation**

Capitol Indemnity Corporation (hereinafter “CIC” or “Capitol Indemnity”) is a Wisconsin stock insurance company writing property and casualty business. The major products marketed by the company include commercial multiple peril, surety, other liability, worker’s compensation, fidelity, inland marine, fire, other accident, and health, products liability, and allied lines. Effective in the first quarter of 2002, Capitol Transamerica contributed to Capitol Indemnity its subsidiary, Capitol Specialty. This transaction made Capitol Specialty a wholly owned subsidiary of Capitol Indemnity and is reflected in the organizational chart used for this report. Also effective January 1, 2002, CIC has a 90% net retention in the affiliated pooling agreement with Platte River Insurance Company, whereby after cessions to unaffiliated reinsurers, all business written or assumed on a going forward basis is combined and reapportioned. For additional information related to the purchase by Alleghany and other changes to the holding company structure, see the section of this report titled “Appendix-Subsequent Events”.

As of December 31, 2001, the company's statutory annual statement reported assets of $263,648,155, liabilities of $159,145,832, and policyholders’ surplus of $104,502,323. Operations for 2001 produced net loss of $10,560,899.

**Capitol Facilities Corporation**

Capitol Facilities Corporation (hereinafter “CFC”) is a wholly owned subsidiary of Capitol Transamerica Corporation. CFC historically facilitated premium-financing opportunities for its affiliated insurance entities. With the implementation of a direct billing program by its insurance affiliates in 1998-99, such arrangements were generally no longer necessary. Therefore, operational activity for CFC is currently limited. Steps are being taken to license CFC as a general agent to potentially facilitate future relationships with other insurance companies offering products not provided by Capitol but desired by its policyholders. Additionally, a licensing initiative is occurring for CFC, which will allow it to collect and pay out premium trust funds on behalf of its affiliated insurance entities in the future.

As of December 31, 2001, the company's unaudited financial statement reported assets of $39,341, liabilities of $0, and unassigned funds and special reserves of $39,341. Operations for 2001 produced net loss of $1,117.

**Platte River Insurance Company**

Platte River Insurance Company (hereinafter “Platte River”), formerly known as Underwriters Insurance Company, was incorporated on January 6, 1972 and commenced business on January 14, 1972. It is domiciled in Nebraska. Effective January 3, 2002, Platte River became an affiliate of Capitol Specialty when it was purchased by Alleghany for approximately $40 million and subsequently changed its name to the one currently used. The seller contractually retained all of the liabilities of Platte River that existed at the time of the sale. Effective January 1, 2002, Platte River has a 10% net retention in the affiliated pooling agreement with CIC, whereby after cessions to unaffiliated reinsurers, all business written or assumed on a going forward basis is combined and reapportioned. For additional information related to the affiliated pooling agreement see the section of this report titled “Reinsurance”. For additional information related to the purchase by Alleghany and other changes to the holding company structure, see the section of this report titled “Appendix-Subsequent Events”.

As of December 31, 2001, the company's statutory annual statement reported assets of $33,016,072, liabilities of $501,876, and unassigned funds and special reserves of $32,514,196. Operations for 2001 produced net income of $2,635,203.

**Affiliated Agreements**

In accordance with an administrative service agreement with CTC, "Capitol Indemnity agrees to provide, or cause to be provided, during the life of this agreement, resource to a staff of experts, especially trained, and of acknowledged proficiency in their respective fields, who shall be available, or be caused to be available, to render services to the company in marketing and sales, accounting, personnel, data processing and systems, legal and tax matters, underwriting and reinsurance, and claims." Through the agreement, Capitol Indemnity prepares and distributes CTC's reports, including payment for any services by independent agencies, travel and reimbursement expenses of directors, and all directors' fees of the company. CTC agrees to pay Capitol Indemnity monthly reimbursements of $10,000 for such general and special services rendered and expenses borne by Capitol Indemnity. Similar agreements have been in effect since 1977, with the latest amendment being effective on January 1, 2002, in which the reimbursement was reduced to $2,500, as several services were eliminated as CTC is no longer publicly traded.

Similar to the administrative service agreement with CTC, Capitol Indemnity provides administrative services to Capitol Specialty, through an agreement between CTC and Capitol Specialty. Effective January 1, 2002, Capitol Indemnity receives $20,000 monthly in consideration for these services.

An office rental and equipment service agreement between CTC and Capitol Specialty whereby CTC receives compensation in consideration of office space and equipment leased to Capitol Specialty. Effective January 1, 2002, CTC receives $1,000 a month from Capitol Specialty related to this agreement.

Capitol Specialty is party to a consolidated federal tax agreement with certain affiliates, whereby it files its federal income tax on a consolidated basis with CTC. Effective on January 1, 2002, a new tax sharing agreement was executed to file on a consolidated basis with Alleghany.

## V. REINSURANCE

As noted earlier, while the company has not written nor assumed any business since 1998, any future writings would be ceded under the following affiliated agreement unless the agreement was terminated. The contracts contained proper insolvency provisions.

**Affiliated Ceding Contract**

| | | |
|---|---|---|
| 1. | Type: | 100% Quota Share |
| | Reinsurer: | Capitol Indemnity Corporation |
| | Scope: | All business written |
| | Retention: | 0% |
| | Coverage: | 100% |
| | Premium: | All premium collected by the ceding company |
| | Commissions: | 25% |
| | Effective date: | August 1, 1997 |
| | Termination: | 12:01 a.m. on any January 1 |

## VI. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported in the December 31, 2001, annual statement to the Commissioner of Insurance. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

**Capitol Specialty Insurance Corporation**
**Assets**
**As of December 31, 2001**

| | Assets | Nonadmitted Assets | Net Admitted Assets |
|---|---|---|---|
| Bonds | $13,686,953 | $ 0 | $13,686,953 |
| Stocks: | | | |
| Common stocks | 520,023 | 0 | 520,023 |
| Cash | 1,819,402 | | 1,819,402 |
| Interest, dividends, and real estate income due and accrued | 274,640 | | 274,640 |
| Total Assets | $16,301,018 | $ | $16,301,018 |

**Capitol Specialty Insurance Corporation**
**Liabilities, Surplus, and Other Funds**
**As of December 31, 2001**

| | |
|---|---|
| Taxes, licenses, and fees (excluding federal and foreign income taxes) | $ 425,000 |
| Federal and foreign income taxes | 22,067 |
| Total Liabilities | 447,067 |
| Common capital stock | 1,500,000 |
| Gross paid in and contributed surplus | 13,475,652 |
| Unassigned funds (surplus) | 878,299 |
| Surplus as Regards Policyholder | 15,853,951 |
| Total Liabilities and Surplus | $16,301,018 |

**Capitol Specialty Insurance Corporation**
**Summary of Operations**
**For the Year 2001**

| | |
|---|---|
| **Underwriting Income** | |
| Loss expenses incurred | 105 |
| Other underwriting expenses incurred | 3,122 |
| Net underwriting gain or (loss) | (3,227) |
| **Investment Income** | |
| Net investment income earned | 12,214 |
| Net realized capital gains or (losses) | 13,717 |
| Net investment gain or (loss) | 25,931 |
| Net income (loss) before dividends to policyholders and before federal and foreign income taxes | 22,704 |
| Dividends to policyholders | 0 |
| Net income (loss) after dividends to policyholders but before federal and foreign income taxes | 22,704 |
| Federal and foreign income taxes incurred | 163,857 |
| Net Loss | $(141,153) |

**Capitol Specialty Insurance Corporation**
**Cash Flow**
**As of December 31, 2001**

| | | | |
|---|---|---|---|
| Premiums collected net of reinsurance | $ 0 | | |
| Loss and loss adjustment expenses paid (net of salvage or subrogation) | 105 | | |
| Underwriting expenses paid | 3,122 | | |
| Cash from underwriting | | $ (3,227) | |
| | | | |
| Investment income (net of investment expense) | 227,578 | | |
| Miscellaneous Income | 1,696 | | |
| Deduct: | | | |
| Federal income taxes paid (recovered) | 6,700 | | |
| | | 222,574 | |
| Net cash from operations | | | $ 219,347 |
| | | | |
| Proceeds from investments sold, matured, or repaid: | | | |
| Bonds | 468,150 | | |
| Stocks | 480,000 | | |
| Total investment proceeds | | 948,150 | |
| | | | |
| Cost of investments acquired (long-term only): | | | |
| Bonds | 11,522,692 | | |
| Stocks | 6,022 | | |
| Total investments acquired | | 11,528,714 | |
| | | | |
| Net cash from investments | | | (10,580,564) |
| | | | |
| Cash provided from financing and miscellaneous sources: | | | |
| Surplus notes, capital and surplus paid in | 11,708,763 | | |
| Total | | 11,708,763 | |
| | | | |
| Cash applied for financing and miscellaneous uses: | | | |
| Dividends to stockholders paid | 500,000 | | |
| Total | | 500,000 | |
| | | | |
| Net cash from financing and miscellaneous sources | | | 11,208,763 |
| | | | |
| Net change in cash and short-term investments | | | 847,546 |
| | | | |
| **Reconciliation** | | | |
| Cash and short-term investments, December 31, 2000 | | | 971,856 |
| Cash and short-term investments, December 31, 2001 | | | $ 1,819,402 |

**Capitol Specialty Insurance Corporation**
**Compulsory and Security Surplus Calculation**
**December 31, 2001**

| | | |
|---|---|---|
| Assets | $16,301,018 | |
| Less liabilities | 447,067 | |
| Adjusted surplus | | $15,853,951 |
| Compulsory surplus ($2 million minimum) | | 2,000,000 |
| Compulsory surplus excess (or deficit) | | $13,853,951 |
| Adjusted surplus (from above) | | $15,853,951 |
| Security surplus: (140% of compulsory surplus, factor reduced 1% for each $33 million in premium written in excess of $10 million, with a minimum factor of 110%) | | 2,800,000 |
| Security surplus excess (or deficit) | | $13,053,951 |

## Capitol Specialty Insurance Corporation
## Reconciliation and Analysis of Surplus
## For the Five-Year Period Ending December 31, 2001

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| Surplus, beginning of year | $6,561,248 | $6,437,879 | $5,865,245 | $4,865,494 | $4,667,964 |
| Net income | 297,036 | 479,019 | 689,133 | 232,388 | (141,153) |
| Net unrealized capital gains or (losses) | 79,595 | (551,653) | (1,188,884) | 70,082 | 118,377 |
| Capital changes: | | | | | |
| Paid in | | | | | 210,000 |
| Surplus adjustments: | | | | | |
| Paid in | | | | | 11,498,763 |
| Net remittances from or to home office | | | | | |
| Dividends to stockholders | (500,000) | (500,000) | (500,000) | (500,000) | (500,000) |
| Surplus, end of year | $6,437,879 | $5,865,245 | $4,865,494 | $4,667,964 | $15,853,951 |

## Capitol Specialty Insurance Corporation
## Insurance Regulatory Information System
## For the Five-Year Period Ending December 31, 2001

Due to the company's lack of operations, it was not required to file its operating ratios with the NAIC. The company began filing operating ratios in 2000. Accordingly, only operating ratios for 2001 were produced by the NAIC's Insurance Regulatory Information System (IRIS) during the period under examination. Exceptional ratios are denoted with asterisks. A discussion of the exceptional ratios may be found after the IRIS ratios.

| | | Ratio | 2001 | |
|---|---|---|---|---|
| | #1 | Gross Premium to Surplus | 0.0% | |
| | #2 | Net Premium to Surplus | 0.0 | |
| | #3 | Change in Net Writings | 0.0 | |
| | #4 | Surplus Aid to Surplus | 0.0 | |
| | #5 | Two-Year Overall Operating Ratio | 0.0 | |
| | #6 | Investment Yield | 0.1* | |
| | #7 | Change in Surplus | 240.0* | |
| | #8 | Liabilities to Liquid Assets | 3.0 | |
| | #9 | Agents' Balances to Surplus | 0.0 | |
| | #10 | One-Year Reserve Devel. to Surplus | 0.0 | |
| | #11 | Two-Year Reserve Devel. to Surplus | 0.0 | |
| | #12 | Estimated Current Reserve Def. To Surplus | 0.0 | |

Ratio No. 6 and No. 7, were both exceptional due to the capital contribution of approximately $11.7 million in 2001. This contribution was made to position the company for writing business in the future.

**Growth of Capitol Specialty Insurance Corporation**

| Year | Admitted Assets | Liabilities | Surplus As Regards Policyholders | Net Income |
|---|---|---|---|---|
| 1997 | $8,256,561 | $1,818,683 | $6,437,878 | $297,036 |
| 1998 | 5,872,954 | 7,709 | 5,865,245 | 479,019 |
| 1999 | 4,873,205 | 7,711 | 4,865,494 | 689,133 |
| 2000 | 4,675,673 | 7,709 | 4,667,964 | 232,388 |
| 2001 | 16,301,018 | 447,067 | 15,853,951 | (141,153) |

As stated earlier, the company has not written nor assumed any business since 1998.

However, management does expect to write on a surplus lines basis commencing in 2003. The large increase in surplus is due to a capital contribution of approximately $11.7 million in 2001. This contribution was made to position the company for writing business in the future.

**Reconciliation of Surplus per Examination**

The company reported $15,853,951 in surplus as regards policyholders as of December 31, 2001. The examination resulted in no adjustments or reclassifications.

## VII. SUMMARY OF EXAMINATION RESULTS

**Compliance with Prior Examination Report Recommendations**

There were four specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Management and Control — It is recommended that the company comply with ch. 617, Wis. Stat., ch. Ins 40, and s. Ins 6.52, Wis. Adm. Code, including but not limited to:

    - Timely filing of the annual registration statement;
    - Accurate reporting of terms of affiliated agreements;
    - Accurate reporting of intercompany transactions that occurred in the period;
    - Reporting material transactions to the commissioner for prior review; and
    - Filing current biographical information on directors.

    Action — Compliance.

2. Management and Control — It is recommended that the company file bylaw amendments with the Commissioner's office in a timely manner in accordance with s. 611.12 (4), Wis. Stat.

    Action — Compliance.

3. Management and Control — It is suggested that the company consider revising its numbering system for amendments to affiliated agreements.

    Action — Compliance is not required. However, current management is revising the numbering system used by the company.

4. Management and Control — It is recommended that the company update its custodial agreement to reflect the current name of the company.

    Action — Compliance.

## Summary of Current Examination Results

### Investment Reconciliations

The examination noted that during 2001, the company had only performed a formal investment reconciliation between the company's records and custodial records at year-end. Effective June 30, 2002, the company implemented controls to perform formal reconciliations on a monthly basis. Timely reconciliations are an essential element of an adequate control environment to ensure investments are properly maintained and accounted for. It is recommended that the company continue to perform formal reconciliations of investments to custodian records on a monthly basis.

### Safekeeping Agreements

All of the company's securities are held by a bank under a safekeeping agreement. The agreement did not contain satisfactory safeguards and controls as specified in the National Association of Insurance Commissioners (NAIC) Examiners Handbook. It is recommended that the company amend its safekeeping agreement to include provisions requiring:

> That the custodian is obligated to indemnify the company for any loss of securities of the company in the trust company's custody occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction; and
>
> That in the event that there is a loss of the securities for which the custodian is obligated to indemnify the company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

## VIII. CONCLUSION

Policyholders' surplus has increased 141.6%, from $6,561,248 on December 31, 1996, to $15,853,951 as of December 31, 2001. The large increase is almost entirely due to an $11.7 million capital contribution in 2001.

Capitol Specialty is currently only licensed in Wisconsin. The company had no direct premium written during the examination period and hasn't assumed any business since 1998. However, management expects to begin writing on a surplus lines basis in 2003. The capital contribution mentioned above is expected to help position the company for that purpose.

The examination resulted in two recommendations, none of which were repeated, from the previous examination. The recommendations made related to improving controls in regard to its invested assets. No adjustments to surplus were made as a result of this examination.

## IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 20 - Investment Reconciliations — It is recommended that the company continue to perform formal reconciliations of investments to custodian records on a monthly basis.

2. Page 20 - Safekeeping Agreements — It is recommended that the company amend its safekeeping agreement to include provisions requiring:

    That the custodian is obligated to indemnify the company for any loss of securities of the company in the trust company's custody occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction; and

    That in the event that there is a loss of the securities for which the custodian is obligated to indemnify the company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

## X. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

| Name | Title |
|---|---|
| Cruz Flores | Data Processing Audit Specialist |
| John Litweiler | Insurance Financial Examiner |
| Rick Anderson | Insurance Financial Examiner |
| Sheur Yang | Insurance Financial Examiner |

Respectfully submitted,

Tim Vande Hey
Examiner-in-Charge
Senior Insurance Financial Examiner

## XI. APPENDIX—SUBSEQUENT EVENTS

As stated earlier, effective January 4, 2002, Alleghany announced the closing of a merger agreement under which Alleghany purchased Capitol Transamerica (Capitol Specialty's ultimate parent at the time) for approximately $182 million in cash. Prior to the purchase Capitol Transamerica was a publicly traded company whose common stock was traded through the National Association of Securities Dealers.

Effective January 3, 2002, in a separate transaction, Alleghany purchased 100% of the common stock of Platte River Insurance Company (Platte River), formerly known as Underwriters Insurance Company. In this way, Platte River became an affiliate of Capitol Indemnity and Capitol Specialty.

Effective January 30, 2002 Capitol Indemnity Corporation acquired all renewal rights and certain other assets of The Connecticut Surety Company ("CSC"), a Connecticut domiciled insurance company, and its affiliates. CSC wrote a $14 million dollar book of commercial surety bonds in thirty states. Most of the bonds were low bond penalty license and permit bonds. At renewal those bond were re-written in Capitol Indemnity or its affiliate, Platte River.

Effective March 31, 2002, Alleghany contributed $22 million in securities to Capitol Transamerica Corporation, which, in turn, contributed these securities to Capitol Indemnity. Also effective in the first quarter of 2002 was the contribution by Capitol Transamerica to Capitol Indemnity of its subsidiary, Capitol Specialty. This transaction made Capitol Specialty a wholly owned subsidiary of Capitol Indemnity.

Subsequent to the transactions noted above, Capitol Indemnity and Platte River, entered into an affiliated pooling arrangement, that was effective January 1, 2002, whereby after cessions to unaffiliated reinsurers, all business written or assumed on a going forward basis is combined and reapportioned. Capitol Indemnity administers all aspects of the pooled business and retains a 90% participation in the net-pooled business, while Platte River retains the remaining 10%.

All of the transactions and agreements mentioned above were properly filed with this office.